VZCZCXYZ0027
PP RUEHWEB

DE RUEHAK #2017/01 3251549
ZNR UUUUU ZZH
P 201549Z NOV 08
FM AMEMBASSY ANKARA
TO RUEHC/SECSTATE WASHDC PRIORITY 8078
INFO RUEHIT/AMCONSUL ISTANBUL PRIORITY 5059
RUEAIIA/CIA WASHDC PRIORITY
RHEHAAA/NSC WASHDC PRIORITY
RUEATRS/TREASURY DEPT WASHDC PRIORITY

UNCLAS ANKARA 002017

SENSITIVE
SIPDIS

TREASURY FOR JOANNA VELTRI AND ALEXANDER CORREA, EEB FOR ANDREW SNOW

E.O. 12958: N/A
TAGS: EFIN ECON TU
SUBJECT: ILL-TIMED RATE REDUCTIONS IN TURKEY

REF: A. ANKARA 2014
¶B. ANKARA 1982
¶C. ANKARA 1978
¶D. ANKARA 1920

¶1. (U) Sensitive but unclassified. Not for Internet distribution.

¶2. (SBU) Summary. In a move analysts called "shocking, premature, futile, and destructive," the Central Bank of the Republic of Turkey (CBRT) on November 19 cut its overnight borrowing rate to 16.25% (down from 16.75%) and its overnight lending rate to 18.75% (down from 19.75%). Turkey watchers had expected only a 50 basis point cut in the lending rate, but the change in the borrowing rate came as a complete surprise. Foreign and domestic analysts were uniformly negative on the timing and wisdom of the cuts. Unless they are followed almost immediately by a new IMF agreement or sharp fiscal spending cuts, analysts think these rate cuts will cause further lira depreciation and capital flight from Turkey. Although Prime Minister Erdogan has substantially softened his public statements about the IMF, no new agreement appears imminent. Market reaction was also negative: the lira fell to 1.76 against the dollar, while the benchmark interest rate jumped to 22.57%. End summary.

The CBRT's Rationale

¶3. (U) In its statement accompanying the rate decision, the CBRT's Monetary Policy Committee (MPC) said the cut was prompted by subdued domestic and external demand conditions, as well as a prediction that inflation would slow more sharply than projected. The MPC emphasized massive declines in commodity prices and claimed that the pass-through from the YTL to inflation would be limited. It also signaled that additional measures would be forthcoming to ease liquidity conditions in the foreign exchange (FX) market. Following the rate cut decision, CBRT also announced extending maturities in the foreign exchange depot market from one week to one month, and decreasing interest rates from 10% to 7% for the purchase of dollars and to 9% for the purchase of euros.

Finally: Serious Talk About an IMF Deal (But Only Talk)

¶4. (U) On November 19, PM Erdogan is reported to have told the AKP's Executive Board that Turkey is discussing $20-40 billion in funding with the IMF. After months of balking at IMF interference and limitations, Erdogan's comments were interpreted by the Turkish press as a signal for an IMF deal to be made soon.

¶5. (SBU) On November 19, IMF Resident Representative Hossain Samiei told us that the IMF and the GOT are still some distance apart from agreeing to terms. While PM Erdogan's long-awaited approval of negotiations is a positive step, much work remains to be done on the technical details of a deal. The GOT and IMF appear still to be far apart on fundamentals of fiscal policy and spending limits. Samiei noted the Fund has more flexibility on the size of a possible stand-by deal with Turkey after Japan's decision to lend up to $100 billion to the IMF.

Analysts Uniformly Pessimistic and Skeptical

¶6. (SBU) At a November 20 Economic Policy Research Foundation of Turkey (TEPAV) conference on the global crisis and its effects on Turkey, an economic columnist from mainstream Hurriyet was highly critical of the rate cut decision. He said unless the GOT was very close to an IMF agreement, this premature rate cut will cause further depreciation in the YTL and pressure the CBRT to sell from its reserves. Former Central Bank Vice Governor Fatih Ozatay, speaking at the same conference, said the rate cut signals an imminent deal with the IMF, warning this is a "very risky step" if no deal is on the horizon.

¶7. (U) Baturalp Candemir, Chief Economist at EFG Istanbul Securities, called the rate cut "premature, futile and destructive." Candemir said the decision raised "question marks about the credibility of the monetary authority". He added that "it is highly unlikely for a rate cut to deliver the desired results unless it is supported by fiscal policy--and we have no indications that fiscal policy will be supportive in the coming months." Candemir does not expect long term interest rates to retreat in response to the drop in short term policy rates. (Note: the day after the rate cut decision, the Government benchmark rate jumped to 22.57%. End note.) If Turkish companies are not able to borrow more from banks or international creditors and consumers are not motivated to consume more, Candemir thinks the rate cut will have no positive effects. Over time, Candemir expects the decision to cause a loss of confidence that will trigger another sell off in Turkish markets.

¶8. (U) Christian Keller, of Barclays Capital, said the rate cut "increased uncertainty when stability was needed." Keller said he fails to see the upside of cutting rates at this point, since Turkey is widely perceived by markets as one of the most vulnerable emerging market currencies. The lira has held up well thus far due to residents' willingness to switch from FX to YTL deposits at local banks, but Keller noted this could quickly turn around if confidence is lost. He called the decision "confusing" and predicted it will not cause Turkish banks to provide more corporate or consumer credit. Regarding the magnitude of an IMF deal, Keller said "size matters, and the timing does too." He estimated that a minimum $20-25 billion program would be needed as soon as possible to ease investors' external financing concerns and act as a catalyst for private capital inflows in 2009.

¶9. (U) Ahmet Akarli of Goldman Sachs called the cuts a "surprise" and said the CBRT is now focused primarily on growth and financial stability risks and is easing monetary conditions aggressively, by cutting rates and allowing the currency to depreciate. He added that the bank is looking to use its FX reserves to ensure that FX correction is orderly. Akarli and many other analysts said it is possible the CBRT knows more than the market and is anticipating a strong IMF program to be agreed on shortly. Akarli warned if no deal is imminent, "the CBRT may be putting its credibility at stake." Akarli agrees with Keller that a $25 billion deal with the IMF is needed soon to restore investor confidence in Turkey.

¶10. (U) Deutsche Securities called the CBRT decision "stronger than we expected" and noted the lending rate has converged to become the reference rate, with the CBRT recently taking on the role of net lender to the market.

While Deutsche Securities said fundamentals warrant easing of monetary policy, they note this rate cut may be risky and premature and be unlikely to be effective in this environment. An analyst at Garanti Securities called the rate cut "a complete surprise," adding the CBRT's focus has now shifted to growth rather than inflation management.

Visit Ankara's Classified Web Site at
http://www.intelink.sgov.gov/wiki/Portal:Turk ey

SILLIMAN